Office of Chief Counsel
Internal Revenue Service

memorandum

CC:NER:UNY:BUF:TL-N-7909-98
ADMelzer

date: APR 13 1999

to: Chief, Examination Division, Upstate New York District
Revenue Agent Dawn DiCarlo, Exam, ESP

from: District Counsel, Upstate New York District, Buffalo

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subject: [redacted]
May Department Store Issue

DISCLOSURE STATEMENT

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

We sent our memorandum dated January 7, 1999 to the National Office to be reviewed. In response to our request, Richard Fultz enclosed the following insights.

Response:

This is a response to your request for Nondocketed Significant Advice Review of your Memorandum received January 7, 1999, which was supplemented with additional facts as we requested on January 20, 1999. We recommend a modification to

the advice included in your memorandum to include the following brief analysis, which clarifies the facts in your memorandum and sets forth the Service's position on this issue as applied to the facts of your case.

Taxpayer initially reported an overpayment of approximately $[redacted] for its [redacted] tax year. $[redacted] of the overpayment was initially applied to the taxpayer's [redacted] tax year.[1] The taxpayer elected to apply the remaining balance of $[redacted] of the [redacted] overpayment against its estimated tax for the succeeding tax year, [redacted]. In [redacted], the Service determined a deficiency of $[redacted] for the taxpayer's [redacted] tax year. The taxpayer agreed with the determination.

As noted in the supplemental information received from you on [redacted], $[redacted] was applied to the first installment and $[redacted] was applied to the second installment. Although the supplemental information states that the balance, $[redacted], was applied to the third installment of estimated taxes for [redacted], the Form 2220 (Underpayment of Estimated Tax by Corporation) for [redacted], indicates that the taxpayer full paid the [redacted] third installment with funds other than the [redacted] overpayment. The taxpayer's representative also states in her letter of [redacted], that the balance of the [redacted] overpayment was only partially utilized for the first and second installments of the [redacted] estimated taxes, and that none of the [redacted] overpayment was used to pay the third and fourth installments. The transcript of account for [redacted] also indicates that the taxpayer made a payment of $[redacted] on September 16, [redacted], which confirms that the third installment was full paid without the use of any of the [redacted] overpayment. We have confirmed this fact with Examining Agent Dawn DiCarlo. The transcript of account for [redacted] also indicates that the fourth installment of $[redacted] was full paid on December 16, [redacted], with funds other than the [redacted] overpayment.

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[1]According to District Counsel's memorandum, the portion of the [redacted] overpayment credited to the [redacted] account was reversed in early [redacted] and applied against the third installment of estimated taxes for [redacted], which resulted in an overpayment that was refunded to the taxpayer. The transcripts of account for [redacted] and [redacted] indicate that the amount was reversed in [redacted] and the balance was not actually applied to the third installment of estimated taxes for [redacted]. We also discussed this matter with Dawn DiCarlo the examining agent responsible for this taxpayer, who confirmed how the [redacted] overpayment was applied to the [redacted] estimated taxes.

The Form 2220 included with the supplemental information provided by your office, is consistent with the position stated in the letter from the taxpayer's representative dated [redacted], that only $[redacted] of the [redacted] overpayment ($[redacted] (1st installment) + $[redacted] (2nd installment) = $[redacted] was used against the estimated taxes due for [redacted]. Consequently, the balance of the [redacted] overpayment of $[redacted] (following the reduction of $[redacted] applied to the 1st and 2nd installments of estimated taxes for [redacted]) exceeded the [redacted] deficiency of $[redacted]. Therefore, as discussed in detail below, the deficiency for [redacted] did not become due and unpaid as a result of the partial application of the overpayment to the first and second installments of estimated taxes for [redacted], and none of the overpayment was applied to the third and fourth installments. Consequently, interest on the [redacted] deficiency does not begin to run until the due date (without extensions) of the tax return for the [redacted] tax year.

The taxpayer contends that interest on this subsequently determined deficiency for [redacted] should begin to run on September 15, [redacted] (the date the return was filed for its [redacted] tax year). We disagree with the taxpayer's position and, therefore, recommend that the memorandum be modified to reflect our opinion of when interest begins to run, and that the supplemental advice you provide indicate that our opinion is appropriate even though it gives the taxpayer greater relief than what it is asking for.

In general, the government is entitled to interest on a deficiency in tax for the period that the tax was due and unpaid. I.R.C. § 6601(a); *Avon Products, Inc. v. United States*, 588 F.2d 342 (2d Cir. 1978). If a deficiency in tax is determined after the taxpayer elected to credit a return overpayment against its estimated tax liability for the next succeeding year, interest will begin to accrue on the amount of the deficiency equal to the amount of the return overpayment as of the effective date of the credit elect. H.R. Rep. No. 98-432 (Part I), 98th Cong., 1st Sess. 190 (Oct. 21, 1983); *see also*, Rev. Rul. 88-98, 1988-2 C.B. 356. Section 413 of the Tax Reform Act of 1984 provides that overpayments of tax will be credited against the estimated income tax for the next succeeding year with full regard to Revenue Ruling 77-475, 1977-2 C.B. 476.[4] Pub. L. No. 98-369, 98 Stat. 494. Revenue Ruling 77-475 provides:

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[4] In 1983, the Service revoked Revenue Ruling 77-475. Rev. Rul. 83-111, 1983-2 C.B. 245. However, in response to tremendous public criticism and expected Congressional action, the Service promulgated Revenue Ruling 84-58, 1984-1 C.B. 254, which reinstated and modified Revenue Ruling 77-475 on March 30, 1984.

> [i]f an overpayment of income tax for a taxable year occurs on or before the due date of the first installment of estimated tax for the succeeding taxable year, the overpayment is available for credit against any installment of estimated tax for such succeeding taxable year and will be credited in accordance with the taxpayer's election.

1977-2 C.B. at 476 (emphasis added). Accordingly, interest on the deficiency in the prior year begins to accrue on the due date of the installment of estimated tax for the succeeding taxable year against which the overpayment was credited in accordance with the taxpayer's designation. H.R. Rep. No. 98-432 (Part I), 98th Cong., 1st Sess. 190 (Oct. 21, 1983); *see also* Rev. Rul. 88-98, 1988-2 C.B. 356. However, the deficiency only becomes both due and unpaid, and thus triggers the running of interest on that deficiency, when the overpayment balance, after the application to the succeeding tax year's estimated taxes, is less than the deficiency for the overpayment year.

Pursuant to Revenue Ruling 84-58, 1984-1 C.B. 254, which modified Revenue Ruling 77-475, the Service generally was crediting a reported overpayment of tax against the taxpayer's first installment of estimated income tax for the succeeding tax year unless the taxpayer attached a statement to its return that designated otherwise. However, in *May Department Stores Co. v. United States*, 36 Fed. Cl. 680 (1996), the Court of Federal Claims concluded that the assumption behind the default rule in Revenue Ruling 84-58 was that the taxpayer had underpaid its first installment of estimated tax for the succeeding tax year. Thus, a return overpayment will not be deemed to be credited for interest purposes to an installment of estimated tax due prior to the filing of the prior year's return if the taxpayer did not designate the particular installment of estimated tax against which to apply the return overpayment and the installments of estimated tax due prior to the filing of the prior year's return were fully paid without the application of the return overpayment. *May Department Stores Co. v. United States*, 36 Fed. Cl. 680 (1996). On August 4, 1997, the Service acquiesced in the *May Department Stores* decision. *May Department Stores Co. v. United States*, AOD CC-1997-008.[5]

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[5] The *May Department Stores* action on decision provides that,

> for deficiency interest purposes, where a taxpayer does not initially designate a reported overpayment to satisfy a particular installment [of estimated tax] for

In light of the *May Department Stores* decision, the Service has reconsidered the manner in which interest on a subsequently determined deficiency is computed under I.R.C. § 6601(a) when the taxpayer makes an election to apply an overpayment to the succeeding year's estimated taxes. When a taxpayer elects to apply an overpayment to the succeeding year's estimated taxes, the overpayment is applied to unpaid installments of estimated tax due on or after the date(s) the overpayment arose, in the order in which they are required to be paid to avoid an addition to tax for failure to pay estimated tax under I.R.C. § 6655 with respect to such year.

The date the overpayment becomes a payment on account of the succeeding year's estimated tax determines the date the prior year's tax became unpaid for purposes of I.R.C. § 6601(a). Prior to that date the government has had the use of the funds with respect to the prior year's tax, and no interest is payable on the overpayment that is the subject of the taxpayer's election. See I.R.C. § 6402(b); Treasury Reg. § 301.6402-3(a)(5) and § 301.6611-1(h)(2)(vii). Interest should be charged from the point the prior year's tax is both due and unpaid. *May Department Stores Co. v. United States*, 36 Fed. Cl. 680 (1996), acq. AOD CC-1997-008 (Aug. 4, 1997); *Avon Products, Inc. v. United States*, 588 F.2d 342 (2d Cir. 1978); Rev. Rul. 88-98, 1988-2 C.B. 356.

Where the overpayment is not needed to satisfy any installment of estimated tax in the succeeding year, the overpayment would be treated as a payment of the succeeding year's income tax. Section 6513(d) provides that if any overpayment of income tax is, in accordance with I.R.C. § 6402(b), claimed as a credit against estimated tax for the succeeding tax year, such amount shall be considered as a payment of income tax for the succeeding taxable year (whether or not claimed as a credit in the return of estimated tax for such succeeding taxable year) and no claim for credit or refund of such overpayment shall be allowed for the taxable year in which

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> the following year, and crediting of the return overpayment is not necessary to fully pay an installment of estimated tax due prior to the filing of the prior year's return, the reported overpayment will not be deemed to be credited to an installment of estimated tax due prior to the filing of the prior year's return.

May Department Stores Co. v. United States, AOD CC-1997-008 (Aug. 4, 1997).

the overpayment arises. See also I.R.C. § 6513(a) which provides that a payment of income tax made before the date prescribed for payment of the tax is considered paid on that date. The date prescribed for payment of tax is the time fixed for filing the return (determined without regard to any extension of time for filing the return). I.R.C. § 6151. Further, it is on this date that the overpayment is treated as a payment for purposes of computing interest on any overpayment of income taxes with respect to the succeeding year under I.R.C. § 6611(a) and (d). Thus, we conclude that the statute requires that an overpayment which the taxpayer elects to credit against estimated tax for the succeeding year must be treated as a payment against the next year's tax liability with an effective date no later than the due date of the next year's return.

The taxpayer's factual situation does not fit within the fact pattern set forth in *May Department Stores* or *Sequa v. United States*, 1998 U.S. Dept. LEXIS 8556 (S.D.N.Y. June 8, 1998) because a portion of the [redacted] overpayment was needed to satisfy the first and second installments of estimated taxes for [redacted] to avoid the addition to tax for failure to pay estimated tax under I.R.C. § 6655.

The District Court case of *Sequa*, stands for the proposition that interest on the deficiency for the first year should not begin to run where there has been no application of the overpayment to pay estimated taxes of subsequent tax years in order to avoid the addition to tax for failure to pay estimated taxes under I.R.C. § 6655, or the overpayment has not been refunded. However, the Service disagrees in part with the *Sequa* decision concerning the starting date of deficiency interest when the overpayment is not utilized to pay the succeeding tax year's estimated taxes. It is the Service's position that in all cases, the overpayment is a payment of the succeeding year's income tax liability no later than the due date (without regard to extensions) of the succeeding year's income tax return.

Although District Counsel's memorandum notes the factual distinction between the facts in the instant case and the facts in *Sequa*, we recommend that the memorandum be modified to note that the Service disagrees with the conclusions reached by the District Court in *Sequa* as to the issue of when interest on the deficiency begins to run where all of the installments of estimated tax for the tax year immediately following the overpayment tax year are full paid. As noted herein, it is the Service's position that even if the overpayment credit is not needed for the estimated taxes for the subsequent tax year, the latest date on which interest will begin to accrue on the subsequently determined deficiency for the first year will be the

due date of the return, without extensions, for the second year. It is on this date that the deficiency for the overpayment year became both due and unpaid and interest should begin to run from that date.

In the instant case, the balance of the [redacted] overpayment, even after the partial application to the first and second installments of estimated taxes for [redacted], exceeded the deficiency and, therefore, deficiency interest does not run from the due date of any of the installments of estimated taxes for [redacted]. However, the [redacted] overpayment is applied to the [redacted] tax liability, which arises as of the due date (without extensions) of the [redacted] tax return, and interest on the [redacted] deficiency begins to run on that date. We recommend taking this position even though the taxpayer claims that interest on the deficiency should begin to run from the earlier date of September 15, [redacted].

Please review the preceding opinion and feel free to call Anne D. Melzer with any questions you might have. Mrs. Melzer can be reached at (716) 551-5614, ext. 30. Thank you for your cooperation in this matter.

JOHN D. STEELE, JR.
District Counsel

APP 4/13/99

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:NER:UNY:BUF:TL-N-7909-98
ADMelzer

date: JAN 07 1999

to: Chief, Quality Measurement Branch, Upstate New York District

from: District Counsel, Upstate New York District, Buffalo

subject: [redacted]

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The following is written in response to your office's memorandum dated November 23, 1998.

FACTS

In the current case, the taxpayer made total estimated tax payments of $[redacted] for the [redacted] tax year. Its [redacted] tax return was filed on September 15, [redacted] showing a tax per return of $[redacted]. The remaining credit after applying the estimated tax payments to the tax was $[redacted] On or about the filing date, a total amount of $[redacted] was transferred out to the [redacted] taxable year. The computer generated allowable interest in

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the amount of $[redacted], which was refunded to the taxpayer on or about [redacted]. The remaining credits of $[redacted] were applied to the first and second estimated payments for [redacted].

All credits to the [redacted] account were reversed in early [redacted]. The $[redacted] of credits was applied to the third estimated tax payment for [redacted]. This resulted in an overpayment of $[redacted], which amount was refunded to the taxpayer with $[redacted] of interest. The $[redacted] of interest originally refunded on [redacted] was never recaptured and does not affect this opinion (statute of limitations on erroneous refund has expired).

In [redacted], the taxpayer and the Internal Revenue Service agreed to a tax deficiency of $[redacted] for the [redacted] tax year. In computing deficiency interest, the Service began interest on March 15, [redacted] (the due date of the return). The taxpayer believes that interest should not begin to run until September 15, [redacted] (the date the return was filed).

ISSUE

Whether interest accrues on the corporate taxpayer's underpayment of tax for [redacted] from the actual due date of the tax return, the due date of the first estimated tax payment for the next succeeding year, the due date of the third estimated tax payment for the next succeeding tax year or the actual date the return was filed under an extension. UIL 6402.01-02; 6601.02-01

DISCUSSION

The Service is allowed to charge a taxpayer interest upon a tax deficiency to compensate the government for the taxpayer's use of money that rightfully belongs to the government. Vick v. Phinney, 414 F.2d 444, 448 (5th Cir. 1969). Interest is not to serve as a penalty. Therefore, the Service can only assess interest when the taxpayer has the use of funds and the tax is both due and unpaid. See Avon Products, Inc. v. United States, 588 F.2d 342 (3rd Cir. 1978).

In Avon Products, the taxpayer filed its 1967 tax return on September 15, 1968. Avon paid approximately $44.5 million in estimated taxes and its return showed a tax liability of approximately $44.483 million. Avon directed that the $115,000 overpayment be credited against Avon's 1968 quarterly estimated tax payment due September 15, 1968. When the Service subsequently determined that Avon's tax liability for 1967 was, in fact, approximately $44.493 million, Avon paid the additional $99,000 due but had still overpaid its 1967 tax liability by approximately $17,000. The Service assessed interest beginning June 15, 1968,

the date that Avon's 1967 taxes were paid.

The Second Circuit held that Avon's taxes became both due and unpaid when Avon directed that its purported overpayment be applied to its 1968 tax liability. Accordingly, during the time period from June 15 through September 15, 1968, Avon had paid more than enough to satisfy its 1967 tax liability. The policy underlying the holding in Avon Products recognizes that until the time that Avon filed its 1967 tax return, purporting to have already overpaid its 1967 taxes, the government had the use of the money that it was entitled to receive from Avon.

Two additional cases have addressed similar circumstances to those present in Avon Products. In May Department Stores Co. v. United States, [96-2 USTC ¶ 50,596] 36 Fed.Cl. 680 (Ct.Cl. 1996), the taxpayer elected to credit a purported $7.9 million overpayment to its first installment of 1984 taxes. The Service later determined that the proper overpayment was only $2.98 million. The Service assessed interest starting May 15, 1984, the date that the first estimated payment for 1984 was due. The taxpayer asserted that the interest assessment should start on October 15, 1984, the date that the taxpayer made its election to apply the overpayment as a credit. May Department Stores, 36 Fed.Cl. at 680-81.

Likewise in 1984, the taxpayer filed its return on October 15, 1985, claiming an overpayment of $5.8 million to be applied to the first installment of the 1985 taxes. The Service subsequently determined that the taxpayer had underpaid its taxes by $740,592. The Service assessed interest starting May 15, 1985, the date that the first estimated tax payment for 1985 was due. The taxpayer asserted that the interest payment should start on October 15, 1985, the date that the taxpayer made its election to apply the overpayment as a credit. Interest on the $740,592 deficiency commencing on April 15, 1985 was not in dispute.

The Court of Claims held, following Avon Products, that the taxpayer's taxes were not due and unpaid during the periods from April 15 through October 15. Consequently, the Service was not entitled to collect interest during that period. May Department Stores, 36 Fed.Cl. at 689.

The second case is Sequa Corporation v. United States [97-1 USTC ¶ 50,317], 1966 U.S. Dist. Lexis 5288, 1-2 (S.D.N.Y. April 19, 1966). Like the taxpayers in Avon Products, May Department Stores, Sequa Corporation reported a $8.7 million overpayment in 1990 which it applied to its 1991 tax liability. Subsequently, Sequa filed an amended return with an additional tax liability of $1.7 million. The Service collected interest upon the $1.7 million from the date Sequa's 1990 tax was due, March 15, 1991, through the

date Sequa's return was filed, September 15, 1991. On this motion to dismiss, the district court followed Avon Products and held that if Sequa's allegations were true, it would be entitled to a refund of interest because its taxes were not both due and unpaid until September 15, 1991. Sequa Corporation at 6.

All three courts support the inescapable conclusion that the Service can only assess interest when a tax is both due and unpaid. In applying these cases to the present factual situation, we believe that interest would be assessable from the date the first estimated tax payment was due. There is a major distinction to be made between the present situation and the fact patterns found in the Avon Products, May Department Store and Sequa Corporation cases. In all three of the previous cases, the taxpayers had made sufficient payments to avoid the estimated tax penalty under I.R.C. § 6655 for the first and second installments of estimated tax without the application of overpayments. The courts concluded that the taxpayers were entitled to "offset" their deficiencies by their overpayments during the period between the first and third installments of estimated income tax. See The May Department Stores Co. v. United States, 36 Fed. Cl. 680 (1996).

In contrast, when the [redacted] income tax return was filed by [redacted], the taxpayer needed to credit its reported overpayment against the first and second installments of estimated income tax for [redacted] to satisfy its estimated tax liability. Under Revenue Ruling 83-111, 1983-2 C.B. 245, a taxpayer with an overpayment of tax from a prior year filing a timely return pursuant to an extension of time to file, could not credit the overpayment to the current year's estimated tax liability prior to the date the return was filed and the taxpayer elected to do so. The taxpayer could elect to credit the overpayment to an estimated tax payment arising after the overpayment arose but before the election was made, such as in the present case.

Where the credit was made to an estimated tax payment arising prior to the election, as here, interest on any overpayment would not be payable and interest on any underpayment which arose because of a deficiency in tax for the prior year would run from the date the credit was effective. May Department Stores Co. v. United States, 36 Fed. Cl. 680 (1996). This holding is codified in Revenue Ruling 84-58, 1984-1 C.B. 254, which supersedes Revenue Ruling 83-111. Hence, interest on the taxpayer's [redacted] tax deficiency begins to accrue as of the date the credit is effective. The effective date of the credit is the due date of the first estimated tax payment to which the overpayment is applied, in this case April 15th, [redacted].

To do otherwise would give the taxpayer a double benefit here. The taxpayer would be allowed to apply its overpayment to two liabilities at one time - the [redacted] tax liability as well as the first two estimated tax payments for [redacted]. The Service would then be deprived of interest from April 15th through September 15th. We do not believe that this would be the correct interpretation of the Avon Products and May Department Store cases.

CONCLUSION

In conclusion, we believe that interest on the [redacted] income tax deficiency of $[redacted] should begin to accrue on April 15, [redacted], the date that the [redacted] income tax liability was first due and unpaid.

Having rendered our opinion, we are closing our file. Should you have any other questions, please feel free to contact Anne D. Melzer at (716) 551-5614, ext. 30. Thank you for your attention to this matter.

JOHN D. STEELE, JR.
District Counsel